Supreme Court, U.S.
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No. _____

In The

Supreme Court of the United States

October Term, 1998

CENEX, INC. AND SUBSIDIARIES,

Petitioners,

v.

UNITED STATES,

Respondent.

On Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Federal Circuit

PETITION FOR A WRIT OF CERTIORARI

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70 pp

QUESTION PRESENTED

Whether, under this Court's decision in *Arkansas Best Corp. v. Commissioner*, 485 U.S. 212 (1988), cooperative ownership of a source of supply of inventory comes within the inventory exception to capital-asset status provided by Congress in 26 U.S.C. § 1221(1), or whether the only transactions that come within this exception are hedging transactions in futures similar to those in *Corn Products Refining Co. v. Commissioner*, 350 U.S. 46 (1955)?

LIST OF PARTIES

Petitioner Cenex, Inc. was merged by operation of law into Harvest States Cooperatives on June 1, 1998, with Harvest States Cooperatives as the surviving entity. The name of the entity was changed at the time of the merger to Cenex Harvest States Cooperatives.

The case below was brought in the name of "Cenex, Inc. and Subsidiaries" because at the time of filing Cenex, Inc. was the parent of an affiliated group of corporations filing consolidated federal income tax returns. The referenced subsidiaries were not individually named as parties.

Pursuant to Rule 29.6, the current entity, Cenex Harvest States Cooperatives, has the following nonwholly owned subsidiaries:

Ag Agency, Inc.

National Cooperative Refinery Association

Cenex/Farmland, Inc.

Cenex/Land O'Lakes Agronomy Company

CF Industries, Inc.

Universal Cooperatives, Inc.

Sparta Foods, Inc.

Ag Processing, Inc.

TABLE OF CONTENTS

Page

QUESTION PRESENTED i

LIST OF PARTIES ii

TABLE OF AUTHORITIES iv

OPINIONS BELOW 1

JURISDICTION 1

STATUTORY PROVISION INVOLVED 1

STATEMENT OF THE CASE 2

A. Facts Material To This Court's Consideration Of The Question Presented 2

B. Proceedings Below 5

REASONS FOR GRANTING THE WRIT 7

I. *Arkansas Best*, In Limiting *Corn Products* To The Inventory Exception To Capital Assets, Did Not Address The Scope Of The Inventory Exception.. 9

II. Prior To *Arkansas Best*, The Lower Courts Held That Many Types Of Assets Besides Hedging Transactions Were Excluded From Capital-Asset Status Under *Corn Products* 11

III. The Court Of Appeals' Misunderstanding of *Arkansas Best* As Limiting The Inventory Exception To Hedging Transactions Such As Those In *Corn Products* Frustrates The Intent Of Congress And Should Be Corrected By This Court 13

CONCLUSION 20

TABLE OF AUTHORITIES

Page

CASES

Arkansas Best Corp. v. Commissioner, 485 U.S. 212 (1988) ..... *passim*

Booth Newspapers, Inc. v. United States, 303 F.2d 916 (Ct. Cl. 1962) 12

Circle K Corp. v. United States, 23 Cl. Ct. 665 (1991) 15, 16, 19

Corn Products Refining Co. v. Commissioner, 350 U.S. 46 (1955) ..... *passim*

FS Services, Inc. v. United States, 413 F.2d 548 (Ct. Cl. 1969) 11, 12

STATUTES

26 U.S.C. § 1221 ..... *passim*

26 U.S.C. § 1221(1) ..... *passim*

28 U.S.C. § 1254(1) 1

PETITION FOR A WRIT OF CERTIORARI

Petitioners Cenex, Inc. and Subsidiaries respectfully petition this Court for a Writ of Certiorari to review the judgment of the United States Court of Appeals for the Federal Circuit in this case.

OPINIONS BELOW

The opinion of the Court of Appeals (App. 1a) is reported at 156 F.3d 1377. The opinion of the Court of Federal Claims (App. 16a) is reported at 38 Fed. Cl. 331.

JURISDICTION

The decision of the court of appeals of which review is sought was rendered in an opinion filed on October 9, 1998. (App. 1a.) The jurisdiction of this Court is invoked pursuant to 28 U.S.C. § 1254(1).

STATUTORY PROVISION INVOLVED

Section 1221(1) of the Internal Revenue Code of 1986, as amended (26 U.S.C. § 1221(1)), provides:

"SEC. 1221. CAPITAL ASSET DEFINED.

For purposes of this subtitle, the term "capital asset" means property held by the taxpayer (whether or not connected with his trade or business), but does not include –

> (1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if at hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. . . . "

STATEMENT OF THE CASE

A. Facts Material To This Court's Consideration Of The Question Presented

Petitioner Cenex, Inc. ("Cenex") is an agricultural cooperative corporation engaged in the wholesale distribution to its member cooperatives of a variety of products and services essential to farmers and ranchers, including refined fuels, agricultural chemicals, farm and home-maintenance equipment, and automotive products.

In the early 1970s, Cenex anticipated major disruptions in its petroleum and gasoline inventory supply due to the worldwide crude oil shortages caused by the OPEC price increases and oil embargo. These anticipated disruptions to its inventory supply were expected to affect Cenex's ability to provide its members with necessary petroleum products. In response, Cenex investigated a number of alternative solutions to its petroleum supply problems. At the time there was no commodity market for petroleum futures, so Cenex had to find another solution.

The only viable alternative that Cenex found was to join with other agricultural cooperatives that were experiencing similar petroleum supply shortages to purchase

and operate an oil refinery. Therefore, in 1975, Cenex and eight other regional cooperatives formed Energy Cooperative, Inc. ("ECI"), a cooperative corporation, for this purpose. As found by the Court of Federal Claims below, the purpose for the organization of ECI was to provide Cenex and the other cooperatives "with an assured supply of petroleum products for their retail patrons and thus to avoid economic disruptions of the sort that occurred during the oil-import shortages experienced in the early 1970's." App. 18a.

The ownership structure of ECI was designed to reflect its purpose of supplying petroleum products to its owner-members. Each of the nine member cooperatives was entitled to purchase one share of common stock, which gave the holder thereof the right to appoint one member of the board of directors. Each member then subscribed to purchase a number of shares of preferred stock (par value of $100) that entitled the member to purchase a pro rata share of ECI's supply of petroleum products. Between 1975 and 1981, Cenex purchased in excess of $14 million worth of ECI preferred stock. The preferred stock had no voting rights, was not entitled to dividends, and had a preference over common stock on liquidation to receive back the cost of the shares. Unlike typical capital stock, therefore, the preferred shares had no income or appreciation rights.

Pursuant to ECI's articles and bylaws, ECI's net earnings from its transactions with each member, if any, were to be distributed to the respective member as patronage dividends, in the form of cash or shares of stock.

Pursuant to the bylaws of ECI, each of the member cooperatives of ECI was obligated to enter into a Member Product Purchase Agreement with ECI. Pursuant to its agreement, Cenex agreed to purchase, and ECI agreed to sell to Cenex, a certain quantity of specified types of refined petroleum products. The price of the products was initially left open, but was to be set at rates that were competitive with prices being charged between unrelated buyers and sellers in the open market. The intention of ECI and its members was that the nine members would purchase the entire available supply of products generated by ECI (or, if necessary, purchased by ECI on the market).

Initially, ECI operated successfully and Cenex purchased substantial amounts of refined petroleum products from ECI. By the late 1970s, however, ECI's operations were handicapped by the steep increase in OPEC crude oil prices and the lack of an assured long-term supply of crude oil. In 1981, ECI filed a voluntary petition under Chapter 11 of the Bankruptcy Code and attempted to reorganize. In 1984, ECI abandoned its efforts to reorganize and filed for liquidation under Chapter 7 of the Bankruptcy Code.

On its tax return for its 1984 taxable year, Cenex claimed an ordinary loss attributable to the worthlessness of the preferred stock that it had purchased in ECI. On audit, the Internal Revenue Service ("IRS") made adjustments to Cenex's 1984 taxable year, based on (among other things) a determination that the preferred stock of ECI was a capital asset in Cenex's hands, so that Cenex recognized a capital loss rather than an ordinary loss when the stock became worthless. These adjustments

resulted in a tax deficiency for the taxable year 1984. Cenex paid the tax, filed an administrative claim for refund and, when the IRS denied the refund claim, filed a refund suit in the Court of Federal Claims.

B. Proceedings Below

Before the Court of Federal Claims, petitioner argued that its loss upon the worthlessness of the preferred stock of ECI must be allowed as an ordinary loss because the preferred stock was an ordinary asset, and not a capital asset, in its hands.[1] It argued specifically that, under Section 1221 of the Internal Revenue Code of 1986, as amended (the "Code") (26 U.S.C. § 1221), the preferred stock of ECI was excluded from the definition of "capital asset" under the so-called inventory exception, which is defined as: "stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. . . . " Code Section 1221(1) (26 U.S.C. § 1221(1)). Petitioner argued that, although its stock in ECI was not literally inventory, it came within the inventory exception of Code Section 1221(1) as construed by

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[1] In both the Court of Federal Claims and the Court of Appeals for the Federal Circuit, petitioner also raised a second, unrelated issue concerning whether payments made to an unrelated corporation, Northern Tier Pipeline Company, were loans or contributions to capital. This issue was decided adversely to petitioner. Petitioner is not seeking review of this part of the decision below.

this Court in *Corn Products Refining Co. v. Commissioner*, 350 U.S. 46 (1955), and *Arkansas Best Corp. v. Commissioner*, 485 U.S. 212 (1988).

The Court of Federal Claims concluded, however, that, after this Court's decision in *Arkansas Best*, stock could be treated as an ordinary asset in the hands of a taxpayer only if the stock was itself inventory, stating: "Unless the taxpayer in question is a dealer in securities, an ownership interest in a corporation cannot fit within even a strained interpretation of the term 'inventory.' " App. 34a. Since petitioner was not a dealer in securities, the court held that petitioner's losses on the ECI preferred stock were capital losses.

The Court of Appeals for the Federal Circuit affirmed the ruling of the Court of Federal Claims. It concluded that petitioner's ownership of stock in ECI did not meet the definition of a hedging transaction as set forth in *Corn Products* because that ownership did not guarantee petitioner a price for or a set quantity of petroleum products. Thus, petitioner's ownership of stock in ECI "did not completely insulate it from the risk of having to purchase petroleum products on the open market." App. 11a. It also noted that the corn futures in *Corn Products* were closely related to actual inventory because they were redeemable for corn, whereas the stock of ECI held by petitioner could not be redeemed for petroleum products. Although it acknowledged that previous decisions had held that ownership of a source of supply of inventory could come within the exceptions, it declined to follow those cases, stating: "[W]e believe the source of supply doctrine is incompatible with *Arkansas Best*." App. 9a. The court therefore held that the ECI stock was a capital

asset in the hands of petitioner, and that petitioner's loss on the stock was a capital loss.

REASONS FOR GRANTING THE WRIT

Important federal income tax consequences turn upon the question of whether an asset is a capital or an ordinary asset in the hands of a taxpayer. In Section 1221 of the Code, Congress defined "capital asset" generally by providing that it includes all property owned by a taxpayer. Congress also was careful to provide, however, certain statutory exceptions to capital treatment, one of which is the so-called inventory exception, Section 1221(1), at issue here.

This Court has addressed those exceptions only twice. In 1955, in *Corn Products*, the Court held that corn futures acquired by a manufacturer of corn products were excluded from the definition of "capital assets," and accordingly gains from their sale were treated as ordinary income. For more than thirty years, the lower courts then attempted to apply *Corn Products*, often in factual contexts very different from the corn futures at issue there. Some courts understood *Corn Products* as creating a new, judicial exception to capital asset treatment, an exception that turned on whether the asset was held for a "business purpose" or an "investment purpose." Some of these cases also involved the so-called "source of supply" doctrine, which recognized that ownership of an entity that was a source of supply of inventory should come within the exceptions and be treated, like the inventory itself, as

an ordinary rather than a capital asset for income tax purposes.

In 1988, in *Arkansas Best*, this Court once again addressed the Section 1221 exceptions to capital-asset status, this time in the context of a holding company that had realized a loss on the sale of shares of a bank. It concluded that its decision in *Corn Products* had not created a new "business purpose" exception, but had involved the application of a particular statutory exception, the inventory exception of Section 1221(1). Since that exception had no application to the case before it, the *Arkansas Best* Court did not otherwise address the inventory exception, and had no occasion to consider the source of supply doctrine.

In response to *Arkansas Best*, however, some lower courts have concluded that the statutory inventory exception may be applied only to the types of hedging transactions that were at issue in the *Corn Products* case. This response represents an erroneously narrow interpretation of what Congress intended in providing for the inventory exception to capital-asset status. Because the lower courts believe that this result is dictated by this Court's opinion in *Arkansas Best*, however, only this Court can correct the lower courts.

The present case thus provides a vehicle for the Court to address an important question that remains unanswered after *Arkansas Best*: whether there are other types of transactions, besides hedging by means of commodity futures, that may qualify for treatment as ordinary gain or loss by coming within the inventory exception to the definition of capital asset in Section 1221.

Specifically, this case presents the question of whether cooperative ownership of another entity that is used to ensure a source of supply of inventory to the taxpayer may qualify as inventory or an inventory-substitute under Section 1221(1). This question is of particular significance to industries in which cooperatives are common, because such cooperatives frequently use ownership of another cooperative entity to guarantee a source of supply for the products that they in turn supply to their members.

I. *Arkansas Best*, In Limiting *Corn Products* To The Inventory Exception To Capital Assets, Did Not Address The Scope Of The Inventory Exception.

In *Corn Products*, this Court held that corn futures held by a manufacturer of corn products in order to ensure for itself an economical supply of the raw products it needed in its manufacturing business did not constitute capital assets in the taxpayer's hands, so that the gain it recognized on sale of the futures contracts resulted in ordinary income. In later analyzing *Corn Products* and its lower court progeny, the *Arkansas Best* Court noted that there was uncertainty among the lower courts as to whether *Corn Products* had created an extra-statutory exception to the definition of capital asset, an exception that arguably applied to all assets acquired and sold for "ordinary business purposes" rather than for "investment purposes." 485 U.S. at 216. The Court concluded, however, that *Corn Products* had only involved an interpretation of the statutory inventory exception of Section 1221(1) and had not created any new, judicial exception. *Id.* at 220. It noted that in *Corn Products* it had described

the taxpayer's futures transactions as "an integral part of its business designed to protect its manufacturing operations against a price increase in its principal raw material and to ensure a ready supply for future manufacturing requirements." *Id.* (quoting *Corn Products*, 350 U.S. at 50). The *Arkansas Best* Court described the futures contracts in *Corn Products* as "an integral part of the taxpayer's inventory-purchase system," and as "substitutes" or "surrogates " for its actual corn inventory. *Id.* at 221.

The *Arkansas Best* Court then addressed the situation of the taxpayer before it, a diversified holding company that had purchased shares of a bank. The holding company claimed an ordinary loss on its sale of the bank shares on the theory that it had acquired and held the shares for a business purpose, and that under *Corn Products* this was sufficient to make the bank shares an ordinary asset. The Court rejected this argument because, as noted above, it read *Corn Products* not as creating a "business purpose" exception to capital assets but merely as interpreting the inventory exception. The *Arkansas Best* Court observed that the taxpayer before it had not even argued that the bank stock fell within the inventory exception. 485 U.S. at 216, 222. The Court therefore stated that "*Corn Products* thus has no application to this case." *Id.* at 222. Because the bank shares did not fall within the inventory exception or any other statutory exception to capital assets, the Court held that the taxpayer realized a capital loss on their sale.

In so holding, the Court in *Arkansas Best* neither overruled *Corn Products* nor limited it to its facts. Specifically, the Court stated: "We conclude that *Corn Products*

is properly interpreted as standing for the narrow proposition that hedging transactions that are an integral part of a business' inventory-purchase system fall within the inventory exclusion of § 1221." 485 U.S. at 222. Because neither party in *Arkansas Best* argued that the inventory exception was at issue, the Court in *Arkansas Best* had nothing further to say regarding the scope of that exception.

II. Prior To *Arkansas Best*, The Lower Courts Held That Many Types Of Assets Besides Hedging Transactions Were Excluded From Capital-Asset Status Under *Corn Products*.

Because *Arkansas Best* did not involve the inventory exception, the Court had no occasion to discuss whether other types of transactions, in addition to the corn futures at issue in *Corn Products*, could constitute such an "integral part of a business' inventory-purchase system" as to come within the inventory exception of Section 1221(1). Although *Arkansas Best* itself did involve the status of stock as a capital or ordinary asset in the taxpayer's hands, because the taxpayer was a holding company that had no inventory, the Court had no occasion to discuss under what circumstances an ownership interest in an entity serving as a source of supply could constitute an integral part of an inventory-purchase system.

In the years between *Corn Products* and *Arkansas Best*, however, the lower courts had grappled with the question of when stock could constitute an ordinary asset under *Corn Products* in the hands of a taxpayer that was not a dealer in securities. For example, in *FS Services, Inc.*

v. United States, 413 F.2d 548 (Ct. Cl. 1969), the United States Court of Claims (predecessor to the Court of Federal Claims that decided this case below) ruled for the taxpayer in a case involving facts similar to those of petitioner. The taxpayer was an agricultural cooperative that sold petroleum products to its members. Along with two other cooperatives, it acquired stock in a corporation that operated an oil refinery, which was intended to supply the taxpayer with a source of refined petroleum products for resale to its customers. The Court of Claims held that the connection between the taxpayer's ownership of stock and its business of selling petroleum products to its customers was close enough so that, under *Corn Products*, the taxpayer recognized an ordinary loss on its sale of the stock. The court did not, however, specifically apply the inventory exception in reaching this result, since it, like many other lower courts and commentators (*see Arkansas Best*, 485 U.S. at 216 & notes 3 & 4), interpreted *Corn Products* as creating a new "business purpose" exception to the definition of capital asset. *See also Booth Newspapers, Inc. v. United States*, 303 F.2d 916 (Ct. Cl. 1962) (holding that a newspaper company's sale of its stock in a producer of newsprint generated ordinary loss).

Although, as discussed above, the *Arkansas Best* Court had not addressed the "source of supply" doctrine, the Court of Appeals for the Federal Circuit nonetheless stated below, in reference to *FS Services* and *Booth Newspapers*, that "we believe the source of supply doctrine is incompatible with *Arkansas Best*." App. 9a. The court then refused to apply the inventory exception to petitioner's cooperative ownership of a source of supply for its

refined petroleum inventory. This misunderstanding of this Court's holding in *Arkansas Best*, and the concomitant narrowing of the inventory exception intended by Congress, merits this Court's review.

III. The Court Of Appeals' Misunderstanding of *Arkansas Best* As Limiting The Inventory Exception To Hedging Transactions Such As Those In *Corn Products* Frustrates The Intent Of Congress And Should Be Corrected By This Court.

As this Court stated in *Corn Products*, "the definition of a capital asset must be narrowly applied and its exclusions interpreted broadly." 350 U.S. at 52. If, however, *Arkansas Best* is read by the lower courts to say that, under *Corn Products*, only hedging transactions involving commodity futures or their equivalents qualify for the inventory exception from capital assets, as happened here, then it is the inventory exception that is being read narrowly instead of broadly. Specifically, taxpayers in industries that must use means other than futures contracts, such as cooperative ownership, to ensure an economic source of inventory supply will receive different tax treatment from those that purchase futures, resulting in a type of discrimination between categories of taxpayers that is not intended by Congress.

This case presents an important example of such disparate treatment. Cooperatives such as petitioner frequently form other cooperative organizations to provide a source of supply for products that they in turn sell to their members. In these cases, the stock is not acquired for investment purposes, and it frequently has few, if any,

of the attributes of investment property. For example, petitioner as shareholder of preferred stock in ECI had no right to dividends or to appreciation (only a preferential right to a return of its cost on liquidation). Preferred stock ownership in ECI was in exact proportion to a member's right to acquire product from ECI. Furthermore, each preferred shareholder was required to enter into a Member Product Purchase Agreement under which it agreed to purchase, and ECI agreed to sell to it, a specified amount of refined petroleum products. In petitioner's hands, these products were inventory, since it was in the business of selling such products to its member customers. Thus, petitioner's preferred stock in ECI was not an investment medium; rather, it was a proxy for petitioner's right to acquire a certain amount of inventory from ECI.

Moreover, under *Corn Products* and *Arkansas Best*, the *form* of ownership of an asset is not determinative of its status; it is necessary to inquire into a taxpayer's *purpose* in acquiring and holding an asset to determine whether that asset qualifies for the inventory exception from capital treatment. It is true that the Court in *Arkansas Best* stated that the *initial* determination as to whether property constitutes a capital asset under Section 1221 "makes irrelevant any consideration of the property's connection with the taxpayer's business. . . . " 485 U.S. at 217. The Court went on to state, however, that "[a] business connection, although irrelevant to the initial determination of whether an item is a capital asset, is relevant in determining the applicability of certain of the statutory exceptions, including the inventory exception." 485 U.S. at 221. The Court thus reaffirmed the appropriateness of the inquiry

it had conducted in *Corn Products* into the connection between the taxpayer's purchase of corn futures and its principal business operation of manufacturing corn products.

Thus, despite *Arkansas Best's* limitation of the holding of *Corn Products* to the inventory exception, *Arkansas Best* continues to require that a court inquire into the connection between a taxpayer's business and its acquisition of property whose status as a capital or an ordinary asset is at issue. It is therefore not enough for a court merely to determine whether a transaction is a "hedging transaction" that is identical or functionally equivalent to the corn futures in *Corn Products*. The proper issue under *Corn Products*, as interpreted by *Arkansas Best*, is whether an asset is "an integral part" of a taxpayer's "inventory-purchase system," or a "substitute" or "surrogate" for inventory, so that it falls within the scope of the exception to capital-asset status provided for in Section 1221(1).

The United States Claims Court viewed *Arkansas Best* in this context in a decision that the Court of Federal Claims (successor to the Claims Court) chose not to follow in its decision below. In *Circle K Corp. v. United States*, 23 Cl. Ct. 665 (1991), the Claims Court held that a taxpayer recognized an ordinary loss on its sale of shares in a corporation that it had acquired for the purpose of securing a stable source of petroleum, which was inventory in its hands. Circle K operated a chain of convenience stores, many of which included self-service gasoline facilities. In the early 1970s, Circle K was faced with the same impending oil shortage as was petitioner. Circle K's solution was to acquire approximately 12% of the stock of NuCorp Energy, Inc. ("NuCorp"), an oil and

gas exploration and development company that owned both oil and gas producing reserves. In connection with its purchase of stock in NuCorp, Circle K entered into an exploration and development agreement with NuCorp that entitled Circle K to a 10% share in any oil produced, and gave it the right to take its share in kind.

In analyzing the taxpayer's argument that the Nucorp shares in its hands fell within the inventory exception of Section 1221(1), the Claims Court considered the "source of supply" cases decided by the lower courts under *Corn Products*, and the effect on them of *Arkansas Best*. It stated: "While these decisions preceded *Arkansas Best*, nowhere did that opinion specifically reject the 'source of supply' principle. . . . In the absence of any definite indication to the contrary, the court feels that a source of supply analysis . . . still is valid. Therefore, the court finds that a source of supply stock purchase may qualify as a hedging transaction if it is an integral part of plaintiff's inventory-purchase system." 23 Cl. Ct. at 672.

In its decision below, the Court of Federal Claims chose not to follow that reasoning. Recognizing "that its rejection of the 'source of supply' principle, as applied to capital stock, runs counter to the holding of *Circle K Corp. v. United States*, 23 Cl. Ct. 665 (1991)," it concluded nonetheless that, unless the taxpayer is a dealer in securities, its ownership of stock in another corporation can never fit within the inventory exception.

The Court of Appeals for the Federal Circuit, in its decision below, never referred to *Circle K*. Rather, the court reverted to a mechanical approach that requires the finding of a "hedging transaction" similar to that in *Corn*

Products. The court concluded that the petitioner's acquisition of the preferred stock of ECI did not constitute a hedge because "Cenex's ownership in ECI did not completely insulate it from the risk of having to purchase petroleum products on the open market." App. 11a. This analysis, however, ignored the explicit finding by the Court of Federal Claims that the purpose of the formation of ECI was "to provide the participating cooperatives with an assured supply of petroleum products for their retail patrons." App. 18a. More significantly, it also imposed a narrower standard for qualification as a non-capital transaction than that established by *Corn Products* itself. The Court in *Corn Products* acknowledged that the taxpayer's purchase of corn futures was only a partial hedge, because the taxpayer had made no effort to protect itself against a decline in prices of corn. 350 U.S. at 49. The Court found that the taxpayer's use of corn futures in fact had a dual purpose: it was "designed to protect its manufacturing operations against a price increase in its principal raw material *and to assure a ready supply for future manufacturing requirements.*" 350 U.S. at 50 (emphasis added). Thus, *Corn Products* recognized the need for a source of supply of inventory, along with some form of price protection, as a circumstance that could qualify an asset as an inventory "substitute" or "surrogate" under Section 1221(1).

Here, although petitioner's ownership of ECI may not have constituted a pure hedge in the strictest sense, the cooperative form of ownership certainly afforded petitioner a measure of inventory price protection, or (in the words of *Corn Products*, 350 U.S. at 48) "the most economical method of obtaining an adequate supply" of

inventory. The cooperative form of ownership guaranteed that the net earnings that ECI as supplier derived from its sales to its member-patrons (including petitioner) were returned to the latter in the form of patronage dividends, so that the members were ensured that they were acquiring their inventory at the most economical price possible.

The court of appeals also erred in holding that petitioner's cooperative ownership in ECI cannot be considered an inventory surrogate because petitioner "cannot redeem the stock for inventory." App. 10a. This statement reveals a blind adherence to the particular type of hedging transaction that the Court considered in *Corn Products*. Although it is true that the preferred shares of ECI (unlike the corn futures in *Corn Products*) could not be directly redeemed for inventory, the preferred stock ownership was inextricably linked to the right to purchase a certain amount of product from ECI. Indeed, under the Member Product Purchase Agreement, petitioner was obligated to pay for a certain amount of product, whether it needed that product or not. By contrast, the taxpayer in *Corn Products* could either take delivery of corn under the futures contracts or sell the futures when they exceeded its need for corn. (It was, in fact, the sale of the futures in the futures market that gave rise to the gain whose character was at issue in the case.) The petroleum products that petitioner was required to purchase from ECI (and that ECI was required to sell to it) under the legal obligations established by both its preferred share ownership and the Member Product Purchase Agreement constituted inventory in petitioner's hands, and all of the petroleum it acquired from ECI was in fact resold to petitioner's customers. Thus, although in form petitioner

held stock in ECI, not inventory, its ownership of that stock was arguably even more "integral" to its inventory-purchase system than were the corn futures in *Corn Products*.[2]

The decision of the Claims Court in *Circle K* and the decisions of the Court of Federal Claims and the Court of Appeals for the Federal Circuit in this case show the confusion that the courts are experiencing after *Arkansas Best*. Despite the proper application of *Arkansas Best* in *Circle K*, the Court of Federal Claims and the Court of Appeals for the Federal Circuit in their decisions below focused too narrowly on the form of the transactions (*i.e.*, whether they resembled the specific hedging transaction at issue in *Corn Products*), and did not understand *Arkansas Best's* continuing admonition that a court must look to the connection between the taxpayer's inventory and the transaction in question.

These errors occurred because those courts felt constrained not to apply the inventory exception to an instance in which the taxpayer attempted to guarantee an economic source of supply, not through hedging transactions such as futures contracts, but through ownership of another asset such as preferred stock in a supply cooperative. In thus rejecting the "source of supply" cases decided under *Corn Products* but before *Arkansas Best*,

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[2] The extent to which the courts below were wrongly influenced by the form of ownership in the transaction is illustrated by the Court of Federal Claims' blanket assertion that, unless a taxpayer is a dealer in securities, its ownership interest in a corporation can *never* fit within the inventory exception. App. 34a.

they have read too narrowly and mechanically the requirement for a "hedging transaction" in order to bring an asset within the inventory exception. Because those courts believed that their narrow reading was required by this Court's decision in *Arkansas Best*, only this Court can correct the misinterpretation and return the inventory exception to the scope intended by Congress. This case presents the Court with an appropriate vehicle to do so.

CONCLUSION

The petition for writ of certiorari should be granted.

Respectfully submitted,

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January 7, 1999

APPENDIX

United States Court of Appeals for the Federal Circuit

98-5046

CENEX, INC., (formerly known as Farmers Union Central Exchange, Inc.), And Subsidiaries,

Plaintiff-Appellant,

v.

UNITED STATES,

Defendant-Appellee.

DECIDED: October 9, 1998

Before MAYER, *Chief Judge*, RICH and RADER, *Circuit Judges*.

MAYER, *Chief Judge*.

Cenex, Inc. appeals the judgment of the United States Court of Federal Claims, No. 92-CV-97, which granted the United States' motion for summary judgment that losses associated with Cenex's investment in Energy Cooperative, Inc. are capital losses and that Cenex's payments to Northern Tier Pipeline Company for shutdown costs were contributions to capital that deserve capital loss treatment. Because the court correctly characterized these losses as capital ones, we affirm.

Background

Cenex, Inc. is an agricultural cooperative corporation that sells, *inter alia*, petroleum products to farmers and ranchers. In 1975, in order to obtain an assured supply of

refined petroleum products, Cenex and eight other regional cooperatives established a corporation, ultimately named Energy Cooperative, Inc. ("ECI"), to operate an oil refinery. ECI's corporate structure was set up so that ownership of ECI stock was required to purchase ECI's petroleum products and ECI's output was allocated among its owners based on the number of shares each held. Between 1975 and 1981, Cenex purchased $14,615,701 of ECI preferred stock and $1,000 of common stock, and received "$129,600 of ECI stock as part of its patronage dividend distribution." Each share of stock had a par value of $100.00. The preferred stock had no voting rights and was not entitled to dividends, but had preference over common stock upon liquidation.

ECI did not have a long-term supply of crude oil, its refinery was old and had a limited capacity to produce unleaded products, and its product prices were not competitive. As a result of these handicaps and other factors, ECI filed for bankruptcy under Chapter 11, 11 U.S.C. §§ 1101-1174, in May 1981, but converted this proceeding to a liquidation under Chapter 7, 11 U.S.C. §§ 701-766, in 1984, which rendered its stock worthless. Cenex's 1984 tax return listed a loss of $14,745,301 attributable to its investment in ECI, which it characterized as ordinary under I.R.C. § 165(a). After an audit, the Internal Revenue Service ("IRS") determined that the loss was a capital one, deductible only in accordance with I.R.C. §§ 165(f), 1211(a), and 1212(a). This characterization is significantly less desirable for Cenex because its ordinary losses are deductible from ordinary gain, whereas its capital losses offset only capital gain, which is generally taxed at a

lower rate than ordinary gain. *See* I.R.C. § 1211(a); *compare* I.R.C. § 1201(a)(2) *with* § 11(b).

During the audit of Cenex's 1984 return, the IRS also determined that Cenex had mischaracterized a loss stemming from Cenex's ownership in Northern Tier Pipeline Co. ("Northern Tier"), which was established to construct and operate a pipeline from Washington state to Minnesota. Cenex purchased stock in and made loans to Northern Tier in 1979. In 1982, Cenex and the other owners entered into an agreement ("the 1982 Agreement") that modified the terms of previous loan notes issued to Northern Tier and established liability for shutdown costs in the event that the company abandoned its plan to construct the pipeline. In 1983, Northern Tier abandoned the pipeline project and made "cash calls" to its owners to cover the costs of shutting down. In 1983 and 1984, Cenex made shutdown payments to Northern Tier of $75,465 and $184,762, respectively. On its 1983 and 1984 tax returns, Cenex deducted these payments as bad debt, which is deductible as an ordinary loss under I.R.C. § 166(a)(1). The IRS ruled that the shutdown payments were not loans, but capital contributions which give rise to capital losses. *See* Treas. Reg. § 1.166-1(c) ("A . . . contribution to capital shall not be considered a debt for the purposes of section 166.").

Cenex sued for a tax refund resulting from these two losses. In response to the parties' cross motions for summary judgment directed to the interpretation of the relevant provisions of the Internal Revenue Code and the 1982 Agreement, the Court of Federal Claims held that Cenex's stock in ECI was a capital asset and that its

shutdown payments to Northern Tier were capital contributions. Cenex appeals.

Discussion

"Summary judgment is appropriate when there is no genuine issue as to any material fact and the moving party is entitled to judgment as a matter of law." *Barseback Kraft AB v. United States*, 121 F.3d 1475, 1479 (Fed. Cir. 1997). In light of the absence of a genuine issue of material fact here, our focus is whether the Court of Federal Claims properly construed provisions of the Internal Revenue Code and the 1982 Agreement. Accordingly, our review is *de novo*. *See id.*; *Gump v. United States*, 86 F.3d 1126, 1127 (Fed. Cir. 1996) ("We review the summary judgment of the Court of Federal Claims, as well as its interpretation and application of the governing law, *de novo*.").

ECI Stock

We first address whether the inventory exception of I.R.C. § 1221(1) applies to Cenex's ownership of ECI stock. Section 1221 defines capital assets as all "property held by the taxpayer (whether or not connected with his trade or business)" except for five types of property enumerated in the section. *Id.* These five "listed exceptions are exclusive." *Arkansas Best Corp. v. Commissioner*, 485 U.S. 212, 218 (1988). The first one includes "stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or

property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business." I.R.C. § 1221(1). Cenex argues that its ownership of stock in ECI qualifies as "other property of a kind which would be properly included in the inventory of the taxpayer if on hand at the close of the taxable year." Recognizing that its ECI stock is not actually inventory,[1] Cenex argues that it should be considered an inventory substitute because it was purchased in order to obtain a supply of petroleum products, which are actual inventory in its business.

The legislative history of section 1221 sheds no light on the type of property qualifying as "other property of a kind which would be properly included in the inventory of the taxpayer if on hand at the close of the taxable

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[1] Although the Code does not define "inventory," the Treasury regulations explain that "inventory should include all finished or partly finished goods and, in the case of raw materials and supplies, only those which have been acquired for sale or which will physically become a part of merchandise intended for sale. . . . Merchandise should be included in the inventory only if title thereto is vested in the taxpayer." Treas. Reg. § 1.471-1; *see also* Random House Unabridged Dictionary 1003 (2d ed. 1993) (defining "inventory" as "merchandise or stock on hand, work in progress, raw materials, finished goods on hand, etc., made each year by a business concern"). Cenex is not in the business of selling securities. *See, e.g., Marrin v. Commissioner*, 147 F.3d 147, 151 (2d Cir. 1998) (securities in the hand of a securities dealer, but not a trader, meet the requirements of § 1221(1)); *Van Suetendael v. Commissioner*, 152 F.2d 654, 654 (2d Cir. 1945) (securities "could not be classified as stock in trade or property subject to inventory unless they were held by the taxpayer primarily for sale to customers in the ordinary course of business").

year." The Supreme Court has interpreted this phrase broadly, however, to include substitutes for inventory, such as "hedging transactions that are an integral part of a business' inventory-purchase system." *Arkansas Best*, 485 U.S. at 222. The Court offered no guidance on the kind of business arrangement or asset that qualifies as this type of transaction except that the corn futures in *Corn Products Refining Co. v. Commissioner*, 350 U.S. 46 (1955), did so.

In *Corn Products*, the taxpayer was a manufacturer of products made from corn, such as starch, syrup, sugar, feed, and oil. The taxpayer's storage capacity could handle only a three week supply of corn. After experiencing sharp increases in the price of spot corn as a result of droughts, the taxpayer began buying corn futures to stabilize its inventory costs. "At harvest time each year it would buy futures when the price appeared favorable. It would take delivery on such contracts as it found necessary to its manufacturing operations and sell the remainder in early summer if no shortage was imminent. If shortages appeared, however, it sold futures only as it bought spot corn for grinding. In this manner it reached a balanced position with reference to any increase in spot corn prices. It made no effort to protect itself against a decline in prices." *Corn Products*, 350 U.S. at 48-49 (footnote omitted). The taxpayer opted to characterize the gains and losses on its futures transactions as capital ones. "Both the Tax Court and the Court of Appeals found [the taxpayer's] futures transactions to be an integral part of its business designed to protect its manufacturing operations against a price increase in its principal raw material and to assure a ready supply for future

manufacturing requirements." *Id.* at 50. Based on this integral relationship between the futures and the taxpayer's manufacturing enterprise, the Treasury's consistent treatment of bona fide hedging transactions as a form of insurance and as ordinary assets, Congress' recognition of an exception for hedging transactions in commodity futures in I.R.C. § 1233(a), and the potential for manipulation of the tax code if sold futures were taxed differently than delivered futures, the Court held that the gains and losses related to the corn futures' sales were ordinary. *See id.* at 50, 53-54.

The Court also reasoned that because "Congress intended that profits and losses arising from the everyday operation of a business be considered as ordinary income or loss rather than capital gain or loss . . . [and section 1221] is an exception from the normal tax requirements of the Internal Revenue Code, the definition of a capital asset must be narrowly applied and its exclusions interpreted broadly." *Id.* at 52 (citations omitted). Subsequent cases interpreted this as creating another exception to the definition of capital assets for assets acquired for business rather than investment purposes, even when these assets could not reasonably be considered within the scope of the enumerations of section 1221. *See, e.g., Campbell Taggart, Inc. v. United States*, 744 F.2d 442, 450-51 (5th Cir. 1984); *FS Services, Inc. v. United States*, 413 F.2d 548, 552-53 (Ct. Cl. 1969); *Booth Newspapers, Inc. v. United States*, 303 F.2d 916, 921 (Ct. Cl. 1962).

Finding "no support in the language of § 1221" for this proposition, however, in *Arkansas Best*, 485 U.S. at 216, 219, the Court clarified the statements of *Corn Products*. The taxpayer in *Arkansas Best*, a diversified holding

company, had acquired sixty-five percent of a bank's stock as an investment, but when the bank began to fail, purchased additional stock for business purposes: to preserve its business reputation by preventing the bank from failing. The taxpayer ultimately sold the stock for a loss, which the Tax Court characterized as ordinary. Applying the post-*Corn Products* cases, the Tax Court concluded that the stock met the judicially-created exception to the definition of capital asset because it was purchased and held for business instead of investment purposes. The Eighth Circuit reversed because the stock fell within the definition of capital asset in section 1221 and did not meet any of the statutory exceptions. The Eighth Circuit also rejected the judicially-created business motive exception on which the taxpayer relied.

The Supreme Court affirmed, explaining that the judicially-created exception was at odds with section 1221's parenthetical phrase, "whether or not connected with his trade or business," and the listed exceptions. *Id.* at 217-18. Furthermore, the business motive test "is subject to the same kind of abuse that the Court condemned in *Corn Products*" because "if capital stock purchased and held for a business purpose is an ordinary asset, whereas the same stock purchased and held with an investment motive is a capital asset, a taxpayer . . . could have significant influence over whether the asset would receive capital or ordinary treatment." *Id.* at 222. Examining *Corn Products*, the Court explained that it "is properly interpreted as involving an application of § 1221's inventory exception" instead of creating a separate business motive exception. *Id.* at 220. The Court emphasized, moreover, that the corn futures in that case qualified as

ordinary assets because they could be considered "surrogates" or "substitutes" for actual inventory. "The close connection between the futures transactions and the taxpayer's business in *Corn Products* was crucial to whether the corn futures could be considered surrogates for the stored inventory of raw corn. For if the futures dealings were not part of the company's inventory-purchase system, and instead amounted simply to speculation in corn futures, *they could not be considered substitutes for the company's corn inventory, and would fall outside even a broad reading of the inventory exclusion.*" *Id.* at 221-22 (emphasis added). It follows, therefore, that surrogates or substitutes for inventory must bear a close relationship to actual inventory and can do so if they are closely related to the taxpayer's inventory-purchase system.

Cenex argues that the Court did not overrule or even address the source of supply cases, such as *Booth Newspapers*, 303 F.2d 916, and *FS Services*, 413 F.2d 548, which interpret section 1221 as requiring the IRS to treat a company's ownership of stock in a supplier of inventory or raw materials as an ordinary asset. Examination of those cases shows, however, that they rely on the rejected, judicially-created business motives exception and do not analyze the stock transactions under the inventory exception. Accordingly, they do not bind us on the issue at hand. Moreover, we believe the source of supply doctrine is incompatible with *Arkansas Best*.

The corn futures in *Corn Products* were closely related to both actual inventory and the inventory-purchase system because they were redeemable for corn, and the taxpayer accepted delivery of corn as needed. Furthermore, the cost of the taxpayer's inventory was directly

related to the cost of the corn futures and the gains and losses that the taxpayer experienced in the futures market were the same as they would have been if it had stored corn in a silo. A close relationship between the cost of the inventory and the cost of the hedging transaction ensures that the deduction produced by losses in the hedging transaction offsets the income generated by selling inventory.

The ECI stock transaction, in contrast, is not closely related to Cenex's inventory-purchase system and cannot fairly be considered an inventory surrogate. Although stock ownership is required to purchase petroleum products, Cenex cannot redeem the stock for inventory. And, because the value of the ECI stock bears little or no relation to the value of the petroleum products, Cenex's loss is not related to the cost of its inventory. The stock transaction's relationship to Cenex's inventory-purchase system is also insufficient to invoke the inventory substitute exception because it neither meets the Treasury regulation's definition of hedging transaction, which requires a reduction in the risk of price changes,[2] nor serves the same hedging function as the corn futures in *Corn Products*. Although the corn futures did not protect against all

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[2] A hedging transaction is "a transaction that a taxpayer enters into in the normal course of the taxpayer's trade or business primarily – (1) [t]o reduce risk of price changes or currency fluctuations with respect to ordinary property . . . that is held or to be held by the taxpayer; or (2) [t]o reduce the risk of interest rate or price changes or currency fluctuations with respect to borrowings made or to be made, or ordinary obligations incurred or to be incurred, by the taxpayer." Treas. Reg. § 1.1221-2.

price fluctuations, they protected against price increases, about which the taxpayer was most concerned, and secured a specific quantity of corn. Cenex's stock ownership, on the other hand, did not guarantee it a price for or quantity of petroleum products. Because ECI did not have a long-term supply of crude oil, its costs to produce petroleum products depended on the market price of crude oil, which left Cenex vulnerable to increases in the price of petroleum products it bought from ECI. ECI's lack of an assured supply of crude oil also prevented it from guaranteeing an output sufficient to meet Cenex's needs. Thus, Cenex's ownership in ECI did not completely insulate it from the risk of having to purchase petroleum products on the open market.

The ECI stock transaction is more akin to vertical integration than it is to an inventory substitute. If Cenex were to produce petroleum products itself, it would not be able to classify its refinery operation as inventory; once petroleum products were produced, they would be considered inventory and other assets would have to meet the requirements of section 1221 to escape classification as capital assets. Allowing Cenex to declare its refinery operation an ordinary asset simply because it owns stock would circumvent Congress' intent in creating only the five exclusions of section 1221. Perhaps excluding stock of an inventory supplier from the definition of "capital asset" is good policy, but we prefer to leave this decision to Congress.

Payments to Northern Tier

Bona fide, wholly worthless debts are deductible from ordinary income. *See* I.R.C. § 166(a)(1). "A bona fide debt is a debt which arises from a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money." Treas. Reg. § 1.166-1(c). Contributions to capital do not qualify as bona fide debt. *See id.* Courts have developed a variety of factors to discern bona fide debt from capital contributions. *See Adelson v. United States*, 737 F.2d 1569, 1571 (Fed. Cir. 1984). These include, for example,

> (1) the names given to the instruments, if any, evidencing the indebtedness; (2) the presence or absence of a fixed maturity date and schedule of payments; (3) the presence or absence of a fixed rate of interest and interest payments; (4) the source of repayments; (5) the adequacy or inadequacy of capitalization; (6) the identity of interest between the creditor and the stockholder; (7) the security, if any, for the advances; (8) the corporation's ability to obtain financing from outside lending institutions; (9) the extent to which the advances were subordinated to the claims of outside creditors; (10) the extent to which the advances were used to acquire capital assets; and (11) the presence or absence of a sinking fund to provide repayments.

Roth Steel Tube Co. v. Commissioner, 800 F.2d 625, 630 (6th Cir. 1986); *see also Adelson*, 737 F.2d at 1572; *Bordo Products Co. v. United States*, 476 F.2d 1312, 1321-25 (Ct. Cl. 1973); *Cuyuna Realty Co. v. United States*, 382 F.2d 298, 302 (Ct. Cl. 1967); *American Processing & Sales Co. v. United States*, 371 F.2d 842, 848 (Ct. Cl. 1967). The "balancing of the

relevant factors depends upon the unique circumstances of each case." *Adelson*, 737 F.2d at 1572.

The trial court found that the language of the 1982 Agreement, which established Cenex's obligation to pay shutdown costs, did not show that the transaction had traditional indicia of bona fide debt. Paragraphs 4 and 5 of the Agreement discuss the shutdown cost obligations. Paragraph 4 reads, "In the event all of the activities on the Pipeline Project are terminated, each party hereto, exclusive of Western, agrees to pay its pro rata share of the initial $750,000 of shutdown costs." Paragraph 5 states that Cenex and some of the other owners "each agrees to pay its pro rata share of any shutdown costs in excess of the initial $750,000 and to limit [other owners'] obligation for shutdown costs to the initial $750,000 as set forth in paragraph 4." The owners' pro rata shares are proportional to their ownership of stock, which suggests that the payments were contributions to capital. *See Bordo*, 476 F.2d at 1324 ("Proportional holdings of debt and stock have always been considered as indicative of equity rather than debt."). Neither paragraph expressly creates an obligation for Northern Tier to repay the money contributed for shutdown costs. Furthermore, such an obligation is contrary to the purpose of the funds. Because shutdown costs arise in the course of ceasing business operations, the owners could not reasonably have expected Northern Tier to repay them.

Also absent from these paragraphs are two key, traditional indicia of debt – a repayment schedule and an interest rate. *See Bordo*, 476 F.2d at 1321-22 ("Classic definitions of debt emphasize the necessity for a fixed or

determinable time when the debtor can be unconditionally required to make repayment. . . . Absent countervailing considerations, the failure to charge a rate of interest commensurate with the risk undertaken points to the conclusion that a capital contribution is involved."). Cenex argues that Paragraph 1 provides interest and repayment terms for all money advanced to Northern Tier. This paragraph amends "[t]he Credit Agreements, any amendments thereto and each of the Notes," to provide that interest is "compounded semi-annually on the first days of January and July each year *at the rates set forth for each individual note.*" (emphasis added). In addition, it states that the interest and principal are due "on the earlier of the date Northern Tier commences construction of the Pipeline Project or the Pipeline Project is terminated whereupon all such amounts will become immediately due and payable."

This language does not provide an interest rate independent of the ones provided by the Notes. Because Paragraphs 4 and 5 similarly fail to provide an interest rate, the transaction is missing this indicium of a creditor-debtor relationship. More damaging to Cenex's position, however, is the provision that accelerates all loans when the pipeline project is terminated. Cenex argues that this provision provides the indicium of a repayment schedule. However, because the shutdown payment obligations do not arise until termination, interpreting Paragraph 1 to provide a repayment schedule for the shutdown payments yields an absurd result – it would require Northern Tier to repay the money earmarked for shutdown costs immediately upon receiving it. As a result, the 1982 Agreement has no repayment schedule.

Conclusion

Accordingly, the judgment of the Court of Federal Claims is affirmed.

AFFIRMED

CENEX, INC. (Formerly Known as Farmers Union Central Exchange, Incorporated) and Subsidiaries, Plaintiff,

v.

The UNITED STATES, Defendant.

No. 92-97 T.

United States Court of Federal Claims.

June 27, 1997.

As Modified July 29, 1997.

As Corrected Aug. 26, 1997.

Sue Ann Nelson and Terrance A. Costello, Doherty, Rumble & Butler, P.A., Minneapolis, MN, for plaintiff.

Mary M. Abate, with whom were Loretta C. Argrett, Assistant Attorney General, and Mildred L. Seidman, Chief, Court of Federal Claims Section, Department of Justice, Washington, DC, for defendant.

OPINION

WIESE, Judge.

Introduction

The plaintiff in this tax refund suit, Cenex, Inc., is an agricultural cooperative corporation engaged in the wholesale distribution, to member cooperatives, of a variety of products and services essential to farmers and ranchers, including refined fuels, agricultural chemicals, farm and home-maintenance equipment, and automotive products. At issue here are questions concerning the

proper tax treatment due losses suffered by Cenex on its stock purchases in two unrelated corporations – Energy Cooperative, Inc. (ECI) and Northern Tier Pipeline Company (Northern Tier), each of which was engaged in a line of business that Cenex saw as an important supplement to its own business needs.

Neither venture proved successful: ECI's business floundered and its stock became worthless; Northern Tier's ambitions to build a petroleum pipeline were abandoned, resulting in unrecovered shutdown costs to Cenex. The resulting losses, claimed by plaintiff in its 1984 corporate income tax return, were disallowed in part by the Internal Revenue Service ["IRS"], thus precipitating this suit for tax refund.

Of the several tax matters in issue, two are presented for decision now on cross-motions for summary judgment.[1] We address, first, whether the loss associated with

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[1] In addition to the issues we address in this opinion, the case also presents the following additional questions to be considered by the court in a later opinion. First, whether plaintiff is correct in claiming that, for purposes of recognizing a tax loss, ECI's stock could not have been considered worthless prior to 1984. Second, whether $1,187,988 paid by Cenex to Atlantic Richfield Company (a creditor) in 1983 may be claimed as a loss in taxable year 1984.

In addition to the above-identified issues, a third issue in the case, since resolved by agreement between the parties, concerned the proper characterization of losses – whether ordinary or capital – claimed by plaintiff for the taxable year 1984 with respect to payments made to creditors of ECI (*i.e.*, $1,187,988 paid to Atlantic Richfield Company and $9,654,230 paid to Continental Illinois Bank). As evident from the parties' briefs and as further acknowledged during the oral argument of

Cenex's investment in ECI qualifies as an ordinary loss, as plaintiff contends, or must instead be treated as a capital loss, as defendant insists; second, whether payments made by Cenex to Northern Tier for shutdown costs qualify as ordinary losses (bad debts), as plaintiff argues, or are properly characterized as contributions to capital, thereby requiring capital loss treatment, as defendant contends. Both issues have been fully briefed and argument in respect to them was heard by the court on June 10, 1997. We decide both issues in defendant's favor.

The ECI Stock Loss

The Factual Background

In 1975, plaintiff, together with eight other regional cooperatives, established CF Petroleum Company, later renamed Energy Cooperative, Inc., a corporation formed to operate an oil refinery at East Chicago, Indiana, that the organizing cooperatives had jointly agreed to purchase from the Atlantic Richfield Company. The common purpose of these two transactions was to provide the participating cooperatives with an assured supply of petroleum products for their retail patrons and thus to avoid economic disruptions of the sort that had occurred during the oil-import shortages experienced in the early 1970's.

ECI never gained a sound financial footing. From the beginning, there were problems: ECI refinery was old and in need of modernization; the refinery's product mix was

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this case, these payments are properly regarded as capital losses.

not commercially advantageous (because of a limited capacity to produce unleaded fuels) and its product prices were not competitive; operations were handicapped by the steep increase of OPEC oil prices in the late 1970's and the lack of an assured long-term supply of crude oil; and working capital deficits frequently translated into operating losses that placed a continuous demand for capital contributions upon the member-owners (the organizing cooperatives). Because of these factors, ECI was locked in a downward financial spiral that resulted eventually in the filing of a voluntary petition in bankruptcy, under Chapter 11 of the Bankruptcy Code, on May 15, 1981 – some five years after operations were first begun.

Efforts were undertaken to secure a buyer for the refinery but these were not successful. Consequently, in 1984, ECI abandoned its efforts to reorganize and decided, instead, to pursue liquidation under Chapter 7 of the Bankruptcy Code. In its tax return for the year 1984, Cenex claimed an ordinary loss of $14,745,301 associated with its investment as a member-owner in ECI Defendant contends that the loss must be treated as a capital loss.[2]

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[2] Although Cenex's tax return shows 1984 as the year in which its investment in ECI became worthless, for financial accounting purposes Cenex had reported the same loss three years earlier – in 1981. Cenex would explain this seeming discrepancy in loss treatment by contending that different standards guide each determination. Defendant disagrees. Its position is essentially that the same business judgment which correctly dictated the write-off of the ECI investment in 1981 also controls the year of loss determination for tax purposes. As

The Statutory Framework

The classification of plaintiff's loss as ordinary or capital is crucial to the resulting tax liability, for while a loss from "sales or exchanges of capital assets shall be allowed only to the extent of gains from such sales or exchanges," I.R.C. § 1211(a),[3] an ordinary loss is not subject to this limitation. In addition, the gain generated from the sale or exchange of a capital asset is generally taxed at a rate lower than the rate applicable to the gain derived from the sale or exchange of an "ordinary" asset. *Compare* I.R.C. § 1201(a)(2) (West 1982), *with* § 11(b). Consequently, setting off the loss against capital gains results in less tax savings than if the amount were set off against a taxpayer's ordinary tax liability. In light of the financial ramifications of the determination to be made, it is not surprising that defendant characterizes the ECI stock as a capital asset, while plaintiff argues that the stock should be classified as inventory, subject to ordinary treatment.

Section 1221 of the I.R.C. broadly defines "capital asset" as "property held by the taxpayer (whether or not connected with his trade or business)," but exempts five categories of property from the definition. The exempted categories include:

> (1) stock in trade of the taxpayer or other property of a kind which would properly be

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noted earlier, *see* note 1, *supra*, the court expects to address this issue in a later opinion.

[3] Although the tax law in place in 1984 applies to the court's inquiry, there has been no intervening change in the substance of § 1211(a). Where relevant provisions are identical, citations will be made to the current I.R.C.

> included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;
>
> (2) property, used in his trade or business, of a character which is subject to the allowance for depreciation . . . or real property used in his trade or business;
>
> (3) a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property . . . ;
>
> (4) accounts or notes receivable acquired in the ordinary course of trade or business for services rendered in the sale of property described in paragraph (1);
>
> (5) a publication of the United States government. . . .

Id.

The issue before the court is whether the ECI stock comes within the first exception, which excludes a taxpayer's "inventory" from the I.R.C.'s definition of capital assets. Regardless of the common-sense notions of "inventory" that § 1221's first exception might bring to mind, the court's determination cannot rest solely on facial interpretations of the statute's provisions. Because this court is not the first to which this question has been posed, the inquiry initially must be framed within the context of existing case law – a context in which the substantive terms of the statute itself have played a consistently secondary role.

Corn Products and Its Progeny

The Supreme Court began to shape the contours of the "capital asset" category under § 1221 in *Corn Products Refining Co. v. Commissioner*, 350 U.S. 46, 76 S.Ct. 20, 100 L.Ed. 29 (1955). In that case, the plaintiff, a manufacturer of corn products with limited storage capacity, was forced to absorb sharp increases in the market price of corn caused by drought-induced supply shortages. To protect itself against future price surges, it began purchasing corn futures – contracts to buy a fixed amount of corn at a future date for a fixed price. If no shortages appeared, it would take delivery only under those contracts needed for the manufacturing process, and sell the rest on the futures market. However, if shortages did appear, it would accept delivery under the contracts, thereby taking advantage of the previously secured favorable prices. *See id.* at 48-49, 76 S.Ct. at 22-23.

The plaintiff in *Corn Products* contended that the gains and losses from the sale of the futures contracts should have been treated as arising from the sale of capital assets. It contended that its futures trading was separate and apart from its manufacturing process. *See id.* at 49, 76 S.Ct. at 22-23. The Court disagreed, finding that "the transactions were vitally important to the company's business as a form of insurance against increases in the price of raw corn," and concluding that "it is difficult to imagine a program more closely geared to a company's manufacturing enterprise or more important to its successful operation." *Id.* at 50, 76 S.Ct. at 23.

More notable than the substance of these factual premises were the resulting legal conclusions reached by

the Court. As "hedging" transactions designed to protect the plaintiff from market fluctuations, the Court ruled that the purchase and sale of corn futures contracts were not to be afforded capital-asset treatment under § 1221. Accordingly, such gains and losses were subject to ordinary treatment under the I.R.C. This ruling was based not on the language of the statutory provision, but on the congressional purpose behind § 1221, as discerned by the Court:

> Admittedly, petitioner's corn futures do not come within the literal language of the exclusions set out in that section. They were not stock in trade, actual inventory, property held for sale to customers or depreciable property used in a trade or business. But the capital-asset provision of [§ 117, the predecessor of § 1221] must not be so broadly applied as to defeat rather than further the purpose of Congress. . . . Congress intended that profits and losses arising from the everyday operation of a business be considered as ordinary income or loss rather than capital gain or loss. The preferential treatment provided by § 117 applies to transactions in property which are not the normal source of business income.

Id. at 51-52, 76 S.Ct. at 24 (citation omitted). And in language that would come to serve as a springboard for future courts grappling with the applicability of § 1221, the Court concluded that, since the section "is an exception from the normal tax requirements of the Internal Revenue Code, the definition of a capital asset must be narrowly applied and its exclusions interpreted broadly." *Id.* at 52, 76 S.Ct. at 24.

The somewhat nebulous holding of *Corn Products* was given a strikingly expanded scope in future cases, as reflected by the Court of Claims in *Booth Newspapers, Inc. v. United States*, 157 Ct.Cl. 886, 303 F.2d 916 (1962). In that case, the plaintiffs were newspaper publishers faced with acute shortages of newsprint from their suppliers. As a remedy, they jointly purchased a small paper mill to provide a supplemental newsprint supply that would offset the recurrent shortages. The publishers intended to sell the paper mill once an adequate newsprint supply could be assured by their regular suppliers, and did so after a number of years of ownership. *See id.*, 303 F.2d at 918. Both publishers deducted the losses incurred as a result of the sale of their paper mill stock from their gross incomes for the taxable year in question, but the deductions were disallowed by the IRS, which reasoned that the stock was a capital asset.

The *Booth Newspapers* court identified the crucial issue as determining whether the stock in the paper mill "constituted a capital asset in the hands of these plaintiffs." *Id.* at 920. Applying § 1221's "property held by a taxpayer" definition of capital assets, the court acknowledged that, "[a]s a general proposition, of course, capital stock does constitute 'property' and, aside from stock sold by dealers in the usual course of their business, does not fall within any of the express exclusions" of the section. *Id.* However, the court went on to note that "the term 'property' as used in section 1221 is an elastic concept and not all-inclusive." *Id.*

Reviewing the reasoning of *Corn Products* and its progeny, the court formulated the applicable rule as follows:

> [I]f securities are purchased by a taxpayer as an integral and necessary act in the conduct of his business, and continue to be so held until the time of their sale, any loss incurred as a result thereof may be fully deducted from gross income as a business expense or ordinary loss. If, on the other hand, an investment purpose be found to have motivated the purchase or holding of the securities, any loss realized upon their ultimate disposition must be treated in accord with the capital asset provisions of the Code.

Id., 303 F.2d at 921.

Because the factual record "amply demonstrates . . . the business motivation of these plaintiffs at the time they undertook to acquire the [paper mill] stock," *id.*, the court held that the stock "was not a capital asset in the hands of these plaintiffs." *Id.* at 922. Plaintiffs were thus entitled to deduct their stock losses from their gross incomes as ordinary losses. *See id.*

The rule emerging from *Booth Newspapers* thus focused simply on whether an asset was acquired for investment purposes or for business purposes. This subjective, intent-based approach governed the inquiry regarding the classification of an asset as "capital" or "ordinary" in a long line of subsequent cases. *See, e.g., Waterman, Largen & Co., Inc. v. United States*, 189 Ct.Cl. 364, 419 F.2d 845, 847 (1969) (applying the "governing principles" of *Booth Newspapers*). Where a taxpayer had acquired stock in another company in order to secure a source of supply, as in *Booth Newspapers*, courts generally ruled that the transaction gave rise to ordinary gains and losses. For example, in *FS Services, Inc. v. United States*, 188 Ct.Cl. 874, 413 F.2d 548 (1969), under circumstances

similar to the present case, a petroleum wholesaler had purchased an interest in a refinery in an effort to counteract supply problems. The court found that the stock "was acquired by taxpayer as an integral and necessary act in the conduct of its business and continued to be so held until its disposition," and thus that the taxpayer was entitled to deduct losses from the stock's sale as ordinary losses. *Id.*, 413 F.2d at 555. *See also Campbell Taggart, Inc. v. United States*, 744 F.2d 442, 450 (5th Cir.1984) (ruling that *Corn Products* doctrine can apply to a holding company's acquisition of securities).

Where a taxpayer's acquisition of an asset reflected both investment and business purposes, courts developed a "mixed-motive" approach under which "ordinary" treatment would be afforded to an asset only if there was no substantial investment intent behind its acquisition. "[S]tock purchased with a substantial investment purpose is a capital asset even if there is a more substantial business motive for the purchase." *W.W. Windle Co. v. Commissioner*, 65 T.C. 694, 712, 1976 WL 3741 (1976). Thus, the focus of the inquiry remained solely on the motives underlying the taxpayer's acquisition of an asset. And the inquiry itself still was viewed as a direct off-shoot of the Supreme Court's reasoning in *Corn Products*. *See Agway, Inc. v. United States*, 207 Ct.Cl. 682, 524 F.2d 1194, 1201 (1975) ("The rule can be stated to be . . . that *Corn Products* will be applied in this court to purchases of company stock to obtain a source of supply, only if there is no substantial investment intent.").

Arkansas Best: Corn Products Revisited

The restrictive interpretation of § 1221's "capital asset" definition, on which the "source of supply" line of cases was founded, continued to enjoy wide acceptance by courts and commentators until the *Corn Products* holding was revisited by the Supreme Court in *Arkansas Best Corp. v. Commissioner*, 485 U.S. 212, 108 S.Ct. 971, 99 L.Ed.2d 183 (1988). In *Arkansas Best*, the plaintiff was a diversified holding company that, based on its need for additional capital, had acquired stock in a bank in 1968. The bank purchased additional shares between 1969 and 1974 before selling the bulk of its stock in 1975. The record showed that the bank had been healthy until 1972, after which time federal examiners classified it as a "problem bank." The Tax Court ruled that the stock purchased by plaintiff before 1972 was a capital asset because it had been acquired with a substantial investment purpose. The stock purchased after that time, however, was subject to ordinary-loss treatment because it had been acquired exclusively for the business purpose of protecting the plaintiff's reputation by infusing the bank with enough capital to avoid failure. *See Arkansas Best v. C.I.R.*, 83 T.C. 640, 654-57, 1984 WL 15624 (1984).

The Court of Appeals reversed the Tax Court, concluding that the bank stock "was a capital asset because it does not fall into one of the statutory exceptions." *Arkansas Best v. C.I.R.*, 800 F.2d 215, 218 (8th Cir.1986). As such, "Arkansas Best's losses upon disposition of the Bank stock are not entitled to ordinary loss treatment, regardless of when or why the stock was acquired." *Id.* at 220.

Before the Supreme Court, the plaintiff argued that § 1221's definition of "capital asset" as "property held by the taxpayer (whether or not connected with his trade or business)" does not include property acquired for a business purpose. *Arkansas Best*, 485 U.S. at 217, 108 S.Ct. at 974-75. The Court began its analysis with the acknowledgment that the motive-based approach to defining a capital asset under § 1221 "finds much support in the academic literature and in the courts." *Id.* at 216, 108 S.Ct. at 974 (footnotes omitted). However, the Court added, "this broad reading finds no support in the language of § 1221." *Id.*

The Court found no basis for making an asset's status as "property" within the meaning of § 1221 turn on the motive behind its acquisition. In fact, the Court reasoned, such a motive test "is not only nowhere mentioned in § 1221, but it is also in direct conflict with the parenthetical phrase 'whether or not connected with his trade or business.' " *Id.* at 217, 108 S.Ct. at 974. The statute's broad definition of capital asset "explicitly makes irrelevant any consideration of the property's connection with the taxpayer's business, whereas [the motive test] would make this factor dispositive." *Id.*[4]

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[4] The Court also rejected the plaintiff's related contention that the five exceptions listed in § 1221 are merely illustrative, rather than exhaustive, "and that courts are therefore free to fashion additional exceptions in order to further the general purposes of the capital-asset provisions." *Arkansas Best*, 485 U.S. at 217, 108 S.Ct. at 975. The "language of the statute," the Court observed, "refutes [this] construction." *Id.*

Most relevant to our inquiry is the final step of the Court's rejection of the plaintiff's position in *Arkansas Best*. "In the end," the Court observed, the plaintiff "places all reliance on its reading of *Corn Products* . . . a reading we believe is too expansive." *Id.* at 219, 108 S.Ct. at 975. After reviewing the outcome of that case, the Court acknowledged that the *Corn Products* Court "did not state explicitly whether the holding was based on a narrow reading of the phrase 'property held by the taxpayer,' or on a broad reading of the inventory exclusion of § 1221." *Id.* at 220, 108 S.Ct. at 976. "In light of the stark language of § 1221," however, the *Arkansas Best* Court went on to hold that *Corn Products* "is properly interpreted as involving an application of § 1221's inventory exception." *Id.*

Under the factual circumstances of *Corn Products*, in which the plaintiff "bought, sold, and took delivery under the futures contracts as required by the company's manufacturing needs," the Court observed that the futures "can 'easily be viewed as surrogates for the raw material itself.' " *Id.* (quoting Boris I. Bittker, *Federal Taxation of Income, Estates and Gifts* ¶ 51.10.3, at 51-62 (1981)). The *Arkansas Best* Court concluded:

> [A]lthough the corn futures were not 'actual inventory,' their use as an integral part of the taxpayer's inventory-purchase system led the Court to treat them as substitutes for the corn inventory such that they came within a broad reading of 'property of a kind which would properly be included in the inventory of the taxpayer' in § 1221.

Id. at 221, 108 S.Ct. at 977.

The Court thereby rejected the notion that "the Court in *Corn Products* intended to create a general exemption from capital-asset status for assets acquired for business purposes." *Id.* The close connection between the taxpayer's futures transactions and its business operation in *Corn Products* "was crucial to whether the corn futures could be considered surrogates for the stored inventory of raw corn." However, this "business connection" was relevant only "in determining the applicability of certain of the statutory exceptions, including the inventory exception." *Id.* In the end, the Court concluded that *Corn Products* "is properly interpreted as standing for the narrow proposition that hedging transactions that are an integral part of a business' inventory-purchase system fall within the inventory exclusion of § 1221." *Id.* at 222, 108 S.Ct. at 977. The case's holding was thus inapplicable to plaintiff, "which is not a dealer in securities," and "has never suggested that the Bank stock falls within the inventory exclusion." *Id.* The Court held that the loss arising from the sale of the stock was a capital loss. *See id.* at 223, 108 S.Ct. at 977-78.

Defendant argues that the Supreme Court's decision in *Arkansas Best* "made clear that all stock is a 'capital asset' within the meaning of § 1221, unless it is held by a securities dealer for sale to customers." The "source of supply" line of cases would thereby no longer be applicable to the purchase and sale of stock. According to defendant, unless plaintiff were a dealer of stock, its interest in the oil refinery would be subject to capital-asset treatment. Plaintiff disagrees, pointing out that the *Arkansas Best* Court was addressing the general applicability of § 1221, not that of the inventory exception. Plaintiff does

assert, however, that the decision in *Arkansas Best* implicitly "reaffirmed" the "source of supply" line of cases by holding that the inventory exception should be interpreted broadly.

While the *Arkansas Best* Court did not explicitly define the scope of the inventory exception under § 1221, its approach to the specific problem before it does shed light on the present viability of plaintiff's "source of supply" argument. Through its circumscription of the *Corn Products* holding, the Court did away with the bulk of the legal assumptions on which the "source of supply" analysis was built. The Court made clear that the motive behind a taxpayer's acquisition of an asset cannot serve as the touchstone of the inquiry concerning its status as capital or ordinary. And contrary to the implications of plaintiffs argument, the Court did not reject the "motive test" as the proper mode of analysis concerning the general applicability of § 1221, only to then embrace it as the all-encompassing determinant of inventory exceptions. Rather, the Court recognized *Corn Futures* as a situation in which the asset in question – corn futures contracts – could be viewed as a surrogate for the actual inventory. The relevance of the "business connection" discussed in *Arkansas Best* arises when courts are faced with assets that are potentially viewable as surrogates for inventory. At that point, courts must draw a distinction between assets that are an "integral part" of a business' inventory-purchase system, and those that are not. *Id.* at 222, 108 S.Ct. at 977. The Court's invocation of a "business connection" is not a mantra by which all assets connected to the operation of a taxpayer's business may gain the status of "inventory."

The implicit underpinnings of the Supreme Court's *Arkansas Best* holding were made explicit in the underlying Court of Appeals opinion, which unmistakably rejected the "source of supply" line of cases emerging from *Corn Products*. *See Arkansas Best v. Commissioner*, 800 F.2d 215 (8th Cir.1986), *aff'd*, 485 U.S. 212, 108 S.Ct. 971, 99 L.Ed.2d 183 (1988). The Court of Appeals acknowledged that "some federal courts have taken the position that capital stock is not a capital asset when acquired to assure a supply of raw materials vital to the taxpayer's business," and have applied either a "business purpose-investment purpose test" or a "substantial investment purpose test" to make this determination. "With all due respect to these courts," the Court of Appeals continued, "it is clear to us that both tests lack a basis in the statutory language, and we reject them." *Id.* at 220. The court's opinion – affirmed by the Supreme Court – disposed of the plaintiff's interpretation of § 1221 as follows:

> We do not read *Corn Products* as either requiring or permitting the courts to decide that capital stock can be anything other than a capital asset under section 1221. It seems to us that one of the last places where the legal system deliberately should foster subjectivity and uncertainty is in the tax code. *Corn Products* and its progeny, which we respectfully view as misbegotten, have done precisely that, leading to increased recourse to the administrative and judicial processes to resolve conflicting contentions about taxpayers' motivations in purchasing capital stock. Congress could have written section 1221 to incorporate some sort of exception regarding capital stock, just as it recognized the unique position of securities dealers in 26 U.S.C. § 1236,

> but it did not do so. We believe that the judiciary lacks authority to create exceptions to section 1221 that Congress did not choose to make.

Id. at 221.

Even before *Arkansas Best*, the expanded application of the *Corn Products* doctrine to situations in which a taxpayer has purchased stock in another company troubled some observers. *See, e.g., Agway, Inc. v. United States*, 207 Ct.Cl. 682, 524 F.2d 1194, 1200 (1975) ("*Corn Products* has been applied in lower courts in a variety of situations which possibly surprise the *Corn Products* court. . . . "). The incongruity between commodity futures – which the *Corn Products* Court viewed as substitutes for actual inventory – and the capital stock of a corporation always has been apparent. Even those courts that endorsed the "source of supply" approach recognized that "[a]s we move from inventory-related corn futures to a more traditional form of capital asset, such as stock, we should be more reluctant to be innovative in further broadening the domain of subjective analysis and unpredictability." W.W. *Windle Co. v. C.I.R.*, 65 T.C. 694, 713, 1976 WL 3741 (1976) (acknowledging that "there must be limits to the liberties we can take with the statutory language of section 1221" because "[w]ords are not infinitely elastic").

Discussion

In the wake of *Arkansas Best*, the incongruity between corn futures and capital stock is even more glaring. Because the *Arkansas Best* Court foreclosed the existence of a judicially crafted, extra-statutory exception to § 1221's definition of capital asset, the only means by

which a court can grant ordinary treatment to capital stock is to hold that ownership of another corporation is functionally equivalent to ownership of inventory. Because of the nature and breadth of investment entailed by ownership of corporate stock – above and beyond that entailed by ownership of inventory – this court cannot hold that the two assets are equivalent for purposes of § 1221.

Plaintiff might indeed have been motivated to acquire stock in an oil refinery by its desire to secure a source of inventory. But through that stock purchase, plaintiff did more than secure a supply of petroleum; plaintiff became the owner of a refining company. It is as if the plaintiff in *Corn Products*, in order to secure a dependable source of corn, had bought a brokerage house that issued corn futures contracts. The Supreme Court would have been hard-pressed to find that shares in the brokerage house were "property of a kind which would properly be included in the inventory of the taxpayer," § 1221(1) – *i.e.*, "surrogates for the raw material itself." *Arkansas Best*, 485 U.S. at 220, 108 S.Ct. at 976 (quoting *Bittker, supra*). In this case, the fact that the intended function of the stock purchase was the securing of a source of petroleum does not negate the myriad collateral functions inherent to the ownership of a corporation, whether sought by the taxpayer or not.

Unless the taxpayer in question is a dealer in securities, an ownership interest in a corporation cannot fit within even a strained interpretation of the term "inventory." Although other courts "have manipulated the *Corn Products* decision to allow the *Corn Products* doctrine to

apply to factual situations outside the commodity hedging transactions for which the exception was created," Virginia L. Briggs & H. Ward Classen, *Arkansas Best: A Return to the Reasoning of Corn Products*, 44 Wash. & Lee L.Rev. 1229, 1251 (1987), this court declines to follow their lead.[5] The court holds that plaintiff's loss on its investment in the ECI stock is properly subject to capital-asset treatment under § 1221.

The Northern Tier Shut-down Costs

The Factual Background

Plaintiff owned shares, along with seven other oil companies, of Northern Tier Pipeline Company, which was established to construct and operate a pipeline from the State of Washington to Minnesota.[6] In 1983, the pipeline project was abandoned and Northern Tier ceased its business activities after its board of directors decided

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[5] The court recognizes that its rejection of the "source of supply" principle, as applied to capital stock, runs counter to the holding of *Circle K Corp. v. United States*, 23 Cl.Ct. 665, 672 (1991). The court in *Circle K*, noting that "nowhere did [the *Arkansas Best*] opinion specifically reject the 'source of supply' principle," held that "a source of supply stock purchase may qualify as a hedging transaction if it is an integral part of plaintiff's inventory-purchase system." *Id.* While courts should strive for consistency in their rulings, for the reasons stated above this court cannot accept the rationale set forth in *Circle K*.

[6] From December 1979 through November 1982, plaintiff purchased $3,662,585 worth of common stock of Northern Tier. From December 1981 through September 1983, plaintiff made loans to Northern Tier in the amount of $524,783, including accrued interest.

not to pursue an application for a needed environmental permit with the State of Washington. Pursuant to a June 1982 agreement, plaintiff subsequently made payments to Northern Tier in response to "cash calls" for costs stemming from the shutdown of the operation. Plaintiff made two such payments in 1983, totaling $75,465, and two more payments in 1984, totaling $184,762.

On its 1983 tax return, plaintiff claimed the loss from the 1983 shutdown payments to Northern Tier as a nonpatronage bad debt deduction. On its original 1984 tax return, plaintiff claimed the loss from the 1984 shutdown payments as a short-term capital loss. In an audit of plaintiff's 1983 tax return, the IRS disputed whether plaintiff's deduction for the 1983 payments should be patronage or nonpatronage, but, according to plaintiff, accepted the position that the loss qualified as a bad debt deduction. Based on this audit determination, plaintiff amended its 1984 tax return to claim the loss from the 1984 shutdown payments as a bad debt deduction. Subsequently, in auditing plaintiff's 1984 return, the IRS ruled that the shutdown payments were not loans, and thus could not serve as the basis for a "bad debt deduction." The IRS determined, rather, that the payments gave rise to a short-term capital loss – a determination challenged here by plaintiff.

The Legal Framework

Under § 166(a)(1) of the I.R.C., a taxpayer is allowed to fully deduct "any debt which becomes worthless within the taxable year." To qualify under § 166, there must exist a "bona fide debt" which "arises from a

debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money." Treas. Reg. § 1.166-1(c). Importantly, "[a] gift or contribution to capital shall not be considered a debt for purposes of section 166." *Id.*

In determining whether a payment is a loan or a contribution to capital, "the taxpayer's motive is not the crucial factor." *Gilbert v. Commissioner,* 248 F.2d 399, 404 (2d Cir.1957). Courts have applied a variety of criteria in making these determinations, but the focus is always on the particular circumstances of the transaction in question. *See Plantation Patterns, Inc. v. Commissioner,* 462 F.2d 712, 719 (5th Cir.1972) ("[E]ach case must be decided on its own facts, and no one standard is controlling."). The "classic debt" is an "unqualified obligation to pay a sum certain at a reasonably fixed maturity date along with a fixed percentage in interest payable regardless of the debtor's income or lack thereof." *Gilbert,* 248 F.2d at 402. And "[w]hile some variation from this formula is not fatal to the taxpayer's effort to have the advance treated as a debt for tax purposes . . . too great a variation will of course preclude such treatment." *Id.* at 402-03 (citations omitted).

Discussion

Plaintiff's characterization of the shutdown payments as loans is based on its reading of the June 1982 Credit Agreement under which they were made. That Agreement, according to plaintiff, "was a valid enforceable obligation to pay a fixed amount of money, provided for an interest rate, and was subject to acceleration in the

event Northern Tier either commenced or abandoned the pipeline project." As such, plaintiff insists, the "traditional indicia of 'debt' envisioned by I.R.C. § 166(a)(1) and Treasury Regulation § 1.166-1(c) were evidenced" by the Agreement.

Plaintiff reads the 1982 Credit Agreement as having surrounded the shutdown payments with the terms and conditions of traditional loans, when in fact the Agreement did nothing of the sort. The Agreement was entered into by Northern Tier and the eight shareholders of Northern Tier, to become effective on June 4, 1982. The primary purpose of the Agreement was to amend Northern Tier's "Credit Agreements," which were defined in the Agreement as "Credit and/or Loan Agreements" concluded "previously" between Northern Tier and its shareholders. The amounts loaned from the shareholders to Northern Tier pursuant to those agreements were "evidenced by notes of Northern Tier." The Agreement proceeded to amend the "Credit Agreements, any amendments thereto and each of the Notes" to provide, in part, that:

> Interest shall be compounded semi-annually on the first days of January and July each year at the rates set forth for each individual note. Such interest, as so compounded, and all principal amounts shall be payable by Northern Tier on the earlier of the date Northern Tier commences construction of the Pipeline Project or the Pipeline Project is terminated whereupon all such amounts will become immediately due and payable.

The Agreement also provided that the parties agreed "to note conspicuously on each of the Notes that said Notes have been amended by this agreement and to attach a copy of this agreement thereto."

Only two paragraphs of the Agreement addressed shutdown costs. The first paragraph provided that, "[i]n the event all of the activities on the Pipeline Project are terminated," seven of the shareholders, including Cenex, agree to pay their "pro rata share of the initial $750,000 of shutdown costs." This pro rata share was to be based on a party's percentage ownership of Northern Tier's outstanding stock as of June 3, 1982. The second paragraph provided that five of the shareholders, including Cenex, agreed to pay pro rata shares of any shutdown costs in excess of $750,000. In the paragraphs addressing shutdown costs, there was no mention of interest, a repayment date, or even a repayment obligation in general. And Northern Tier's subsequent requests to the shareholders for cash at the various times the shutdown costs arose – i.e. the "cash calls" – referenced only the June 1982 Agreement; the requests themselves did not contain any new terms or conditions under which the payments were to be made.

Under the terms of the 1982 Agreement, the only indications that shareholders' payments would give rise to enforceable obligations, or that interest would accrue, were made in reference to already existing loans from the shareholders to Northern Tier. The Agreement specifically amended loan and credit agreements "previously" entered into. In addition, the Agreement required the included amendments to be attached to the Notes themselves – a requirement that appears to presume the Notes'

current existence. No mention was made of future loans, credit agreements, or notes, and no indication was given that the amendments would apply prospectively in the event that future loans were made.

An even clearer indication of the Agreement's function comes from its structure. The language regarding interest and repayment acceleration is found in a self-contained section addressing the existing loans and credit agreements. The provisions governing the allocation of shutdown costs among the shareholders are found in separately numbered paragraphs, and no intended overlap between the sections is even remotely discernible. Furthermore, if plaintiff's interpretation were to be adopted, and the provisions governing the existing loans were applied as well to the future shutdown costs, the substance of the terms would make little sense. The Agreement provided that the loaned amounts would become payable by Northern Tier if the pipeline project were terminated. Under plaintiff's reading, this means that the amounts for shutdown costs loaned from the shareholders to Northern Tier would become payable upon the project's termination. However, shutdown costs do not even begin to arise until a project is, in fact, terminated, so shareholders could hardly demand repayment before they have even been asked to pay the amounts in the first place.

Terms regarding interest accrual also would have no meaning. The Agreement provides that interest would be compounded semi-annually "at the rates set forth for each individual note." No interest rates were included in Northern Tier's subsequent "cash calls." Even if the

Agreement could be applied in its entirety, interest payments could not be read into any of the shutdown cost payments.

In setting forth the allocation of shutdown costs among Northern Tier's shareholders, the parties to the 1982 Agreement were not undertaking a new series of loans to their troubled company. Rather, they were merely recognizing their responsibilities as shareholders in the event that Northern Tier failed completely. The shareholders could not reasonably expect Northern Tier to repay the shutdown costs, plus interest, when those costs would only be incurred after the company ceased business operations. This common-sense notion is confirmed by the 1982 Agreement upon which plaintiff relies. There is nothing expressed in the language of the Agreement or by logical implication thereunder to lead one to believe that plaintiff's payments of shutdown costs were loans, and not capital contributions, to Northern Tier. The court thus holds that the amounts advanced to Northern Tier by plaintiff in taxable year 1984 were properly classifiable as short-term capital losses.[7]

Conclusion

The court holds that the loss plaintiff suffered as a result of its investment in ECI must be treated as a capital loss. Further, the court holds that the amounts advanced

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[7] Because "[c]ontract interpretation is a matter of law and thus is amenable to decision on summary judgment," *Government Systems Advisors, Inc. v. United States*, 847 F.2d 811, 813 n. 1 (Fed.Cir.1988), this issue may be resolved on the basis of the parties' motions and oral argument.

by plaintiff to Northern Tier to cover shutdown costs are also properly classified as capital in nature. The entry of judgment is to be deferred pending the parties attempts to resolve the two remaining issues in this case.

IN THE UNITED STATES COURT OF FEDERAL CLAIMS

No. 92-97 T
(Judge John P. Wiese)

CENEX, INC. (FORMERLY KNOWN AS FARMERS UNION CENTERAL EXCHANGE, INC.), AND SUBSIDIARIES,

Plaintiffs

v.

THE UNITED STATES,

Defendant

STIPULATION FOR ENTRY OF JUDGMENT

NOV 5 1997

The parties, through their counsel, hereby stipulate and agree that judgment may be entered in favor of defendant and against plaintiffs, on the basis of the Court's decision filed June 27, 1997. The parties further agree: (1) that the Court's decision of June 27, 1997, results in a deficiency in federal income tax for plaintiffs' taxable year ending September 30, 1984, that is barred for assessment or collection by the statute of limitations; (2) that there are issues in this case that have not yet been decided; (3) that, in the event that the Court's decision of June 27, 1997, is not reversed or modified on appeal, the resolution by the Court of the undecided issues would not result in an overpayment for plaintiffs' taxable year ending September 30, 1984; (4) that, in the event that the Court's decision of June 27, 1997, is reversed or modified on appeal, the Court will decide all of the remaining

issues; and (5) that each party shall bear its own costs of this litigation, including attorneys' fees.

Respectfully submitted,

Nov. 4, 1997
Date

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IN THE UNITED STATES COURT OF FEDERAL CLAIMS

No. 92-97 T

CENEX, INC. (FORMERLY KNOWN AS FARMERS UNION CENTRAL EXCHANGE, INC.), AND SUBSIDIARIES,

v.

THE UNITED STATES

JUDGMENT

(Filed Nov. 19, 1997)

Pursuant to the court's June 27, 1997, published Opinion; the subsequent Order dated August 26, 1997, correcting said published Opinion; and the parties' November 5, 1997, Stipulation for Entry of Judgment,

IT IS ORDERED AND ADJUDGED this date, pursuant to Rule 58, that judgment is entered in favor of defendant and against plaintiffs on the basis of the court's above referred to published Opinion, and the parties' Stipulation. Each party shall bear its own costs of this litigation, including attorneys' fees.

David A. Lampen
Clerk of Court

November 19, 1997

By: /s/ Illegible
Deputy Clerk

NOTE: As to appeal, 60 days from this date, see RCFC 72, re number of copies and listing of *all plaintiffs*. Filing fee is $105.00.